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Jenna Amato Moran
University at Buffalo School of Law (Student)

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INDEPENDENT CONTRACTOR OR EMPLOYEE? MISCLASSIFICATION OF WORKERS AND ITS EFFECT ON THE STATE

JENNA AMATO MORAN[†]

I. INTRODUCTION

The United States Government Accountability Office estimates that one-third of the nation's workforce is made up of contingent workers.¹ Workers are "contingent" when they engage in a conditional, transitory, or alternative employment arrangement.² Examples include part-time work, independent contractor status, or employment through a temporary agency.³ Though independent contractors are only one category of contingent workers, they make up the majority at an estimated seventy percent.⁴ An independent contractor is a worker who is an "independent agent."⁵ Black's Law Dictionary defines independent contractor as "one who is entrusted to undertake a specific project but who is left free to do the assigned work and to choose the method for accomplishing it."⁶ As this paper will explain, this

[†] J.D. Candidate, Concentration in Labor & Employment Law, Class of 2010, University at Buffalo Law School, State University of New York. The author would like to thank Professor Diane Avery and Professor James Atleson for their helpful comments and guidance. Any mistakes or omissions are solely the responsibility of the author.

¹ U.S. GOV'T ACCOUNTABILITY OFFICE, EMPLOYMENT ARRANGEMENTS: IMPROVED OUTREACH COULD HELP ENSURE PROPER WORKER CLASSIFICATION 10 (2006) [hereinafter GAO, EMPLOYMENT ARRANGEMENTS].

² Nearly all employment is "at-will" and is presumed to be technically "contingent," as the relationship can be terminated by either party without cause. See 82 AM. JUR. 2D *Wrongful Discharge* § 2 (2009). The term "contingent," as used in this paper, however, identifies those who are situated outside of even the traditional "at-will" employment relationship.

³ Eileen Silverstein & Peter Goselin, *Intentionally Impermanent Employment and the Paradox of Productivity*, 26 STETSON L. REV. 1, 7-8 (1996).

⁴ Michael J. Gray, et al., *Benefits and Pitfalls of the Contingent Workforce*, 782 PLI/Lit 645, 659 (2008).

⁵ *Id.* at 661.

⁶ BLACK'S LAW DICTIONARY 785 (8th ed. 2004).

simple definition lacks the substance to allow employers and administrative agencies to consistently determine if a worker is an employee or an independent contractor.

Government agencies are increasingly involved in cases of misclassification of workers, where employers incorrectly label employees as independent contractors. Due to the difficulty of ascertaining which factors establish independent contractor status, misclassification is often unintentional. Government agencies, however, frequently encounter intentional or fraudulent misclassification, where employers label workers as independent contractors in order to cut the cost of labor, limit employer liability, or gain the upper hand in a tight labor market.⁷

The use of – and misclassification of – independent contractors is an increasingly popular strategy. In the 1980s, many American manufacturers used a “just-in-time” strategy to manage their inventory. They only kept the amount of inventory on hand that was needed at one particular moment. This saved storage space costs and allowed employers more flexibility if demand were to drop suddenly. According to Steven Greenhouse, a journalist for the New York Times, businesses have begun to employ this same method for their workforce.⁸ Keeping an entire staff on hand is expensive, because each worker must be paid daily, regardless of how much work comes in. Instead, employers have found it useful to staff their offices, factories, and warehouses with contingent workers, including independent contractors. “[F]or corporate America, they’re essentially a disposable workforce, discarded as soon as they’re not needed anymore.”⁹ Using a just-in-time workforce is cheaper for business, because the employer can drive down wages without worrying about damaging employee morale, and the employer is not liable for severance and unemployment insurance costs when workers are laid off. This money-saving

⁷ LINDA H. DONAHUE, JAMES RYAN LAMARC & FRED B. KOTLER, *THE COST OF WORKER MISCLASSIFICATION IN NEW YORK STATE* 3 (2007).

⁸ STEVEN GREENHOUSE, *THE BIG SQUEEZE: TOUGH TIMES FOR THE AMERICAN WORKER* 117 (2008).

⁹ *Id.*

measure allows the employer to be more flexible, but at what true cost?

In this paper, I will describe the various classification standards that exist to determine whether a worker is truly an independent contractor or an employee. I will also discuss the consequences of misclassification, as well as attempts by government to regulate and enforce the proper classification of workers. The State of New York will be used as a case study throughout this analysis. While misclassification of workers is an issue in all fifty states, New York provides a good example of a state that is in the midst of investigating options for reducing the frequency of employer misclassification. Governor David Patterson recently announced that New York will suffer a deficit of \$50 billion over the next three years.¹⁰ Various factors have played a hand in deepening the financial crisis in the state. One of these factors is the misclassification of workers, which has diminished the amount of revenue that the state collects from employers. Furthermore, it makes remedying the misclassification issue much more important, as it provides an opportunity for New York State to recover much-needed revenue.

I will conclude this paper by proposing solutions for more accurate classification of workers and more efficient regulation and enforcement by government. I will also demonstrate how the issue of worker misclassification may progress in light of the current economic recession.

II. CLASSIFICATION STANDARDS

a. The Test Under Common Law

Courts, government agencies, and states use various standards to determine the classification of workers. Further increasing confusion, various standards are used within each of

¹⁰ Danny Hakim, *Paterson Proposes Cuts to Close Deficit*, N.Y. TIMES, Oct. 16, 2009, at A23, available at <http://www.nytimes.com/2009/10/16/nyregion/16budget.html>.

these groups. For example, the Internal Revenue Service, a federal agency, employs a different test from the United States Department of Labor, another federal agency. The Department of Labor itself employs different tests depending on what federal law it is enforcing. Most standards for classifying workers spring from the employer's right to control the worker, as clearly evidenced by the most popular standard: the common law test.

The common law test is frequently referred to as the "right-to-control" test.¹¹ The factors for this test originate from the Restatement (Second) of Agency, under the subheading, "Torts of Servants."¹² The factors include:

- (1) the extent of control which, by the agreement, the master may exercise over the details of the work;
- (2) whether or not the one employed is engaged in a distinct occupation or business;
- (3) the kind of occupation, with reference to whether in the locality, the work is usually done under the direction of the employer or by a specialist without supervision;
- (4) the skill required in the particular occupation;
- (5) whether the employer or the workman supplies the instrumentalities, tools, and the place of work for the person doing the work;
- (6) the length of time for which the person is employed;
- (7) the method of payment, whether by the time or by the job;
- (8) whether or not the work is a part of the regular business of the employer;
- (9) whether or not the parties believe they are creating the relation of master and servant; and
- (10) whether the principal is or is not in business.¹³

¹¹ 13 EMP. COORD. PERS. MANUAL § 9:60 (2010).

¹² See RESTATEMENT (SECOND) OF AGENCY §220 (2)(a)-(j) (1958).

¹³ *Id.*

These factors are weighed and balanced. It is not the case that each factor must be met. In sum, the test examines the control that the employer has over *what* work is done and *how* that work is done. Even if the employer never exercises that control, if he has the right to, the worker is likely an employee.¹⁴

A broader version of the common law right-to-control test is known as the “ABC test,” used by some states in place of common law. Under the ABC test, the presumption is that a worker is an employee. To be considered an independent contractor, the employer must be able to prove conditions A, B, and C:

- (A) The individual is free from any direction or control in performing the services.
- (B) The services are performed outside the usual course of the employer's business or are performed away from any of the employer's regular business locations.
- (C) The individual is customarily engaged in an independent trade, occupation, business, or profession.¹⁵

b. Tests Utilized by the Federal Government

1. Internal Revenue Service

The Internal Revenue Service (IRS) monitors worker status for purposes of wage withholding. The original IRS test was comprised of twenty factors falling under three categories: Behavioral Control, Financial Control, and Relationship of the Parties.¹⁶ The test examined and balanced the factors as follows:

¹⁴ See 13 EMP. COORD. PERS. MANUAL § 9:49 (2010).

¹⁵ *Id.* § 9:60 (2010).

¹⁶ INTERNAL REVENUE SERVICE, INDEPENDENT CONTRACTOR OR EMPLOYEE, No. 1779 (2008), *available at* <http://www.irs.gov/pub/irs-pdf/p1779.pdf> [hereinafter INDEPENDENT CONTRACTOR OR EMPLOYEE].

Behavioral Control

- (1) Instructions: If the employer directs where, when, or how work is done, the worker is likely an employee. This is similar to the right-of-control common law test.
- (2) Training: If the employer provides training so that the worker performs in a particular manner and with a particular result, the worker is likely an employee. This is especially true if the training is provided at regular intervals.
- (3) Order or sequence: If the employer requires the worker to perform his tasks in a particular order or sequence, or retains the right to establish a particular order or sequence, the worker is likely an employee.
- (4) Assistance: If the employer hires, supervises, and pays assistants to aid the worker, the worker is likely an employee.
- (5) Furnishing of tools and materials: If the employer provides the supplies, materials, equipment, and other tools necessary to perform the work, the worker is an employee dependent on his employer.
- (6) Oral or written reports: If the employer requires the worker to submit reports at regular intervals, the worker is likely an employee.
- (7) Payment: If the employer pays the worker by salary or by hour, week, or month, the worker is likely an employee. If the worker is paid when he or she bills for services performed, or is paid on commission, the worker is likely an independent contractor.
- (8) Doing work on employer's premises: If the employer requires the worker to perform his/her services on the premises, where the employer can have control over the worker, the worker is likely an employee.

- (9) Set hours of work: If the employer requires the worker to perform a set number of work hours, sets the worker's schedule, or retains approval rights over the worker's schedule, the worker is likely an employee. If the employer does not approve the worker's schedule, the worker is likely an independent contractor.
- (10) Full time required: If the employer requires the worker to work on a full-time basis, the worker is likely an employee.
- (11) Working for more than one firm at a time: If the employer does not allow the worker to perform work for another firm so long as it is performing work for the employer's firm, the worker is likely an employee. However, a worker can be an employee of multiple firms at the same time.
- (12) Making services available to the public: If the employer does not allow the worker to perform his work for the public as a free service, the worker is likely an employee.

Financial Control

- (13) Significant investment: If the worker must make a significant monetary investment in order to perform his services, he is independent of the employer and is not an employee. There is no set dollar limit that qualifies as a "significant investment;" it is determined on a case-by-case basis.
- (14) Payment of business and/or traveling expenses: If the worker must expend money for business or business-related travel, and the employer pays these expenses, the worker is likely an employee. In this case, the employer generally has the ability to control the extent of the employee's business or travel expenses.

- (15) Realization of profit or loss: If the worker does not have the opportunity to profit (or lose) from his work, he is an employee. The employer is in the capacity of receiving the money directly from the client and has the opportunity for profit or loss.

Relationship of the Parties

- (16) Services rendered personally: If the worker must perform the work personally, and cannot delegate the tasks, he/she is an employee.
- (17) Integration: If the employer uses the worker as part of the course of normal business operations, the worker is likely an employee. In this case, the success of the business may be directly related to the success of the individual employee.
- (18) Continuing relationship: If the employer and the worker have a longstanding, continuing relationship, the worker is likely an employee. This includes work that is done at recurring intervals or services performed by a worker who is “on call.”
- (19) Right to discharge: If the employer may fire or dismiss the worker, the worker is likely an employee.
- (20) Right to terminate: If the worker can terminate the work relationship and not be liable for completion of a particular job or service, the worker is likely an employee. If the worker remains liable for a job or service, he or she is an independent contractor.¹⁷

In the past, none of these factors were considered decisive. However, some of the twenty factors may have been considered to weigh more heavily than the other seven.¹⁸

¹⁷ 13 EMP. COORD. PERS. MANUAL § 9:51 (2010).

¹⁸ *Id.* § 9:52 (2010). These factors include: (a), (b), (l), (m), (n), (o), (p), (q), (r), and (s).

The IRS test has now been “simplified” to three factors, matching the three categories in the old twenty factor test: behavioral control, financial control, and relationship between the two parties.¹⁹ Behavioral control examines whether the business “has a right to direct or control how the work is done through instructions, training or other means.”²⁰ Financial control asks whether the business “has a right to direct or control the financial and business aspects of the worker's job.”²¹ The relationship between the parties examines “how the workers and the business owner perceive their relationship.”²² The analysis of each of these three factors involves examining the issues that were enumerated in the original twenty factor test. It appears to this author that the three factor test is not a “simplification” of the twenty factor test, as purported; it is merely a restructuring of the original twenty factors.²³ Hence, it remains important to understand the original twenty factor test for complete analysis of IRS classification.

2. Union Protection and Wage & Hour Laws

Many federal statutes have their own standards for identifying employees and distinguishing them from independent contractors and other types of contingent workers. Among these are the National Labor Relations Act (NLRA) and the Fair Labor Standards Act (FLSA), which both focus on economic factors as the dividing line in the classification scheme.

¹⁹ See INDEPENDENT CONTRACTOR OR EMPLOYEE, *supra* note 16.

²⁰ Internal Revenue Service, Employee vs. Independent Contractor - Ten Tips for Business Owners, <http://www.irs.gov/newsroom/article/0,,id=173423,00.html> (last visited May 10, 2010).

²¹ *Id.*

²² *Id.*

²³ See Richard J. Reibstein, et al., *The Risk of Using Independent Contractors*, N.Y. L.J., May 15, 2008, at 1 (referring to the new test as “supposedly more simplified”) (emphasis added).

i. The National Labor Relations Act

The National Labor Relations Board (NLRB) began using an “economic facts” test to classify workers with the inception of the *Hearst* standard in 1944.²⁴ In *Hearst*, the Supreme Court held that the correct way to classify workers under the NLRA was to look at the economic facts of the situation to determine if the relationship was within the purpose of the Act.²⁵ The newsboys in *Hearst* were economically dependent enough that the employer had the ability to harm them through the “evils the [NLRA] was designed to eradicate.”²⁶ Further, as employees, the newsboys would surely benefit from the remedies provided by the NLRA. The *Hearst* classification scheme was focused on whether the actual relationship fit the purpose of the Act. Because the workers were suffering from a harm that the Act was intended to protect against, the court essentially read the definition of employee broadly enough to fit the worker into the protected class.²⁷

The Supreme Court determined that the definition of employee under the NLRA was intended to be broad, so that even those workers who failed the traditional right of control test could be classified as employees under the *Hearst* standard.²⁸ Congress quickly reacted to this expanded definition with the 1947 Taft-Hartley Amendments, which expressly exempted independent contractors from coverage under the NLRA, regardless of

²⁴ NLRB v. Hearst Publications, Inc., 322 U.S. 111 (1944).

²⁵ *Id.* at 127.

²⁶ *Id.*

²⁷ “[W]hen . . . the economic facts of the relation make it more nearly one of employment than of independent business enterprise with respect to the ends sought to be accomplished by the legislation, those characteristics may outweigh technical legal classification for purposes unrelated to the statute’s objectives and bring the relation within its protections.” *Id.* at 128.

²⁸ See Kenneth G. Dau-Schmidt, *The Labor Market Transformed: Adapting Labor and Employment Law to the Rise of the Contingent Work Force*, 52 WASH. & LEE L. REV. 879, 884 (1995).

economic dependence.²⁹ The NLRA now states that the term employee “includes any employee . . . but shall not include . . . any individual having the status of independent contractor.”³⁰ With this legislative overruling of the *Hearst* standard, it is no longer simple to distinguish an independent contractor from an employee under the Act.

The National Labor Relations Board has since applied the common law right-to-control test in its case-by-case examination.³¹ In reviewing Board decisions, courts have applied the same analysis.³² “The common law of agency is the standard to measure employee status . . . [and the courts] . . . have no authority to change it.”³³ The courts have generally considered all of the factors in the test as equally important to the analysis.³⁴ However, *FedEx Home Delivery v. NLRB* highlights a recent shift in the court’s use of the common law test under the NLRA.³⁵ In *FedEx*, the court reversed a Board determination that FedEx must bargain with its delivery route drivers despite the company’s attempt to label them as independent contractors.³⁶ The Circuit Court of Appeals determined that the drivers were, in fact, independent contractors.³⁷ The court held that while all of the common law factors are indispensable to the test, the multitude of factors was often far too broad and produced “unwieldy” or inaccurate results.³⁸ The most pertinent factor, introduced in *FedEx*, is the opportunity for

²⁹ See National Labor Relations Act, 29 U.S.C. § 152 (2008); see also Dau-Schmidt, *supra* note 28, at 885.

³⁰ 29 U.S.C. § 152(3).

³¹ See, e.g., *Roadway Package Sys., Inc.*, 326 N.L.R.B. 842, 851 (1998).

³² See, e.g., *NLRB v. Amber Delivery Serv., Inc.*, 651 F.2d 57, 60 (1st Cir. 1981).

³³ *Roadway Package*, 326 N.L.R.B. at 850. This holding reflects the *Chevron* standard that courts should defer to agency determinations. See *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

³⁴ “[The] test encompasses a careful examination of all factors and not just those that involve a right of control.” *Roadway Package*, 326 N.L.R.B. at 850.

³⁵ *FedEx Home Delivery v. NLRB*, 563 F.3d 492 (D.C. Cir. 2009).

³⁶ *Id.*

³⁷ *Id.* at 504.

³⁸ *Id.* at 497.

entrepreneurial gain or loss.³⁹ The FedEx drivers' entrepreneurship centered on their ability to "own their routes – as in they can sell them, trade them, or just plain give them away."⁴⁰ Interestingly, the court's analysis concentrated on entrepreneurial *opportunity*, not evidence of actual entrepreneurship among the drivers, if any existed at all.⁴¹ This recent development is worthy of careful monitoring, as it signals a shift in the standard of classification of workers under the NLRA.

ii. The Fair Labor Standards Act

The Fair Labor Standards Act regulates wages and hours for employees, but does not contain a concise definition of the term "employee." It states that an employee is "any individual employed by an employer."⁴² Nor does the statute's definition of "to employ" help in narrowing the term of art; "to employ" is broadly defined as "to suffer or permit to work."⁴³ Nevertheless, the FLSA provides clear guidance for distinguishing between employees and independent contractors based on a narrower "economic reality" test. The test examines whether the worker is not only under the control of the employer (as in the common law right-to-control test), but is also economically dependent on the employer. The analysis is based on six factors:

- (1) the extent of the individual's investment in the equipment and facilities;
- (2) the individual's opportunity for profit or loss;
- (3) the degree of control exercised by others over the individual's work;
- (4) the importance of the services to the alleged employer's business (i.e., whether the service

³⁹ See generally *id.*

⁴⁰ *Id.* at 502.

⁴¹ *Id.* (citing *C.C. Eastern, Inc. v. NLRB*, 60 F.3d 855, 860 (D.C. Cir. 1995)).

⁴² 29 U.S.C. § 203(e)(1) (2008).

⁴³ *Id.* § 203(g).

- performed is an integral part of the business);
- (5) the permanency of the relationship between the work and the employer; and,
- (6) the skill required of the individual in performing the work.⁴⁴

The first two factors on the list focus on the economic reality of the worker's relationship with the employer. First, the test takes into account the amount of money the worker is required to put into outfitting himself or herself for the job. As is often the case, independent contractors must invest in materials and equipment that an employer would normally provide to an employee for the completion of a task. The extent to which an employer requires a large amount of investment from the worker will help determine if that worker is truly independent. The second factor in the list is analogous to the question of opportunity for entrepreneurial gain or loss as currently used under the NLRA standard.

Is there a difference between the FLSA economic reality test and the court's focus on entrepreneurial opportunity in *FedEx*? Both seem to concentrate on the worker's ability to be successful without reliance on the employer. In NLRA cases, the worker must merely have the *opportunity* for personal economic success to be an independent contractor, but need not have *acted* upon that opportunity. Meanwhile, under the FLSA, an independent contractor must have the same opportunity for entrepreneurship, but must also be economically independent *in reality* from the employer. The FLSA test goes further than the NLRA to narrow the breadth of the independent contractor definition. If a worker is economically bound to his employer or his employer's demands, he is economically dependent on the employment relationship and must be treated as an employee. The FLSA test is similar in this regard to the *Hearst* economic facts test, where the circumstances of the existing economic relationship between the parties are analyzed.

⁴⁴ 13 EMP. COORD. PERS. MANUAL § 9:62 (2010).

It is worthwhile to inquire whether the *FedEx* case would have the same result under the FLSA standard. Under the Circuit Court's holding that the workers were independent contractors, the FedEx drivers satisfied the requirements of opportunity for entrepreneurial gain or loss. The court admitted, however, that the drivers were required by the company to make large expenditures for equipment and uniforms. "Servicing a route is not cheap; one needs a truck (which the contractor pays for) and a driver (which the contractor pays for, either directly or in kind)."⁴⁵ The drivers were also responsible for the regular operating and maintenance costs inherent with the vehicle.⁴⁶ These costs are not incidental, unlike such costs as requiring a construction worker to bring his own hammer to the jobsite. The cost of procuring and maintaining a large delivery truck is a sufficient financial burden that may satisfy the economic reality test under the FLSA.⁴⁷ Whereas the FedEx drivers are considered independent contractors under the NLRA, it is likely they may be employees for purposes of the FLSA.

3. Other Statutes Enforced by the U.S. Department of Labor

Other federal statutes offer protections and rights to employees that are not afforded to independent contractors. Accordingly, they contain their own definitions of employee and apply various classification standards for distinguishing between different types of workers. Title I of the Employee Retirement Income Security Act (ERISA), Title VII, the Age Discrimination in Employment Act (ADEA), the Americans with Disabilities Act

⁴⁵ *FedEx*, 563 F.3d at 500.

⁴⁶ *Id.* at 497.

⁴⁷ *Cf. Estrada v. FedEx Ground Package Sys., Inc.*, 64 Cal. Rptr. 3d 327, 336 (Cal. Ct. App. 2007). While *Estrada* is decided under the California Labor Code, not the FLSA, the court holds that the employer's control over the employee's expenditures on equipment and uniforms is substantial enough to classify the workers as employees. *Id.*

(ADA), and the Family and Medical Leave Act (FMLA) all define employee as “any individual employed by an employer,” which is not necessarily helpful.⁴⁸ The Occupational Safety and Health Act (OSHA) is no more helpful when it states that employee means “an employee of an employer who is employed in a business of his employer which affects commerce.”⁴⁹

These statutes all utilize the common law test or an expanded version of the common law test. The Supreme Court has held that, under ERISA, the common law test of right-to-control should be used.⁵⁰ The other statutes falling under Department of Labor auspices depend on an expanded version of the common law test.⁵¹ This expanded analysis combines the right-to-control test with some additional questions about financial dependency which are similar to those in the FLSA “economic reality” test.⁵²

c. The Test in New York State

The courts have found that no single factor or group of factors conclusively define an employer-employee relationship. Rather, all factors must be examined to determine the degree of supervision, direction and control. You are an employer if you control what will be done and how it will be done, i.e, the manner, means and results.⁵³

⁴⁸ 29 U.S.C. § 1002(6) (2008) [ERISA]; 42 U.S.C. § 2000(e)(f) (2008) [Title VII]; 29 U.S.C. § 630(f) (2008) [ADEA]; 42 U.S.C. §12111(4) (2008) [ADA]; 29 U.S.C. § 2611(3) (2008) [FMLA].

⁴⁹ 29 U.S.C. § 652(6) (2008).

⁵⁰ See *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 323 (1992). The court based its classification of a worker as an independent contractor on the common law test instead of the “declared policy and purposes” of the Act. *Id.* at 321.

⁵¹ See Dean L. Silverberg, *What Is an Employee? Independent Contractor vs. Employee Status* (1998) at Section I.B.3 (on file with author).

⁵² For a list of the test’s relevant factors, see U.S. EQUAL OPPORTUNITY EMPLOYMENT COMM’N, EEOC COMPLIANCE MANUAL, SECTION 2: THRESHOLD ISSUES at 2-III(A)(1) (2009), <http://www.eeoc.gov/policy/docs/threshold.html#2-III-A-1>.

⁵³ N.Y. State Dep’t of Labor, *Independent Contractors*, <http://www.labor.state.ny.us/ui/dande/ic.shtm> (last visited May 10, 2010).

The New York State Department of Labor employs the common law right-to-control test in its examination of worker classification. It defines an employee as “a worker who performs services for compensation under the supervision, direction and control of an employer.”⁵⁴ New York has also outlined specific actions that, if taken by a worker, are automatically indicative of independent contractor status, including:

- (1) Holding a Federal Employer Identification Number (FEIN) from the IRS, or filing business or self-employment income tax returns with the IRS based on work or service performed the previous calendar year;
- (2) Maintaining a separate business establishment;
- (3) Performing work that is different than the primary work of the hiring business and performing work for other businesses as well;
- (4) Operating under a specific contract, being responsible for satisfactory performance of work, being subject to profit or loss in performing the specific work under such contract, and being in a position to succeed or fail if the business’s expenses exceed income;
- (5) Obtaining a liability insurance policy (and if needed, workers’ compensation and disability benefits insurance policies) under its own legal business name and FEIN;
- (6) Having recurring business liabilities and obligations;
- (7) Having its own advertising, such as commercials, phone book listing, and/or business cards;

⁵⁴ N.Y. State Dep’t of Labor, New York State Covered and Excluded Employment, <http://www.labor.state.ny.us/ui/dande/covered1.shtml> (last visited May 10, 2010).

- (8) Providing all equipment and materials necessary to fulfill the contract;
- (9) Controlling the time and manner in which the work is done; and,
- (10) Working with his or her own operating permit, contract, or authority.⁵⁵

This is a helpful list for the employer because it includes practical items that are easily recognizable; for example, an employer should know if a worker has his own FEIN, or can easily discover so by asking. The factors laid out under this list, however, are more indicative of the workers who are clearly independent contractors and may even hold themselves out to be so. The issue of misclassification is more complex for those workers whose status cannot be ascertained through a facial examination of their external actions.

III. CONSEQUENCES OF MISCLASSIFICATION

a. In General

As one prominent management consultant has observed, use of independent contractors means a potential savings of the 20% to 40% of labor costs associated with benefits, and that savings is a powerful motivator.⁵⁶

Workers who are classified as independent contractors do not receive the economic and social benefits inherent to the employer-employee relationship. Employer-sponsored benefits, such as health insurance, were popularized by “historical accident”

⁵⁵ N.Y. State Workers’ Comp. Bd., *Who Is An Employee Under the Workers’ Compensation Law?*, <http://www.wcb.state.ny.us/content/main/Employers/Employers.jsp> (follow “Who Is an Independent Contractor?” hyperlink) (last visited May 10, 2010).

⁵⁶ Silverstein & Goselin, *supra* note 3, at 9 (citing TIM STALNAKER, EMPLOYER’S GUIDE TO USING INDEPENDENT CONTRACTORS 143 (1993)).

during World War II.⁵⁷ Labor was scarce during the war, and the ability to attract workers was further restrained by government-imposed wage controls.⁵⁸ This caused employers to develop stronger benefits packages to provide additional incentives to laborers.⁵⁹ Employee benefits are now part of the normal employment conditions expected by workers in the United States, including pensions, health benefits, paid holidays and vacation, and job stability. In addition, employees are guaranteed their right to bargain collectively. These are the hallmarks of the traditional employment arrangement.

Workers in a contingent arrangement, such as independent contractors, do not enjoy these same benefits. They are not subject to the protection of wage and hour laws either, meaning that wages can be purposely depressed, hours can be long, and the work can be hard or even dangerous. For example, an employer is required to comply with OSHA regulations to protect the health and safety of its employees, but is exempt from those regulations when independent contractors are dealing with the same hazardous materials.⁶⁰ The employer need not even be overly concerned with the possibility of a toxic spill because independent contractors are barred from collecting workers' compensation.⁶¹ It is important to note, however, that employers are not immune to tort liability from independent contractors, as they are from their own employees.⁶² This is a cost-benefit decision that the employer must make – whether to hire employees and comply with costly, time-consuming OSHA regulations, or to use independent contractors and be susceptible to occasional tort liability.

In an example of a severe cost-cutting measure, some employers have gone as far as to lay off their employees one day,

⁵⁷ David A. Pratt, *The Past, Present, and Future of Retiree Health Benefits*, 3 J. HEALTH & BIOMEDICAL L. 103, 105 (2007).

⁵⁸ *See id.*

⁵⁹ *See id.*

⁶⁰ Dau-Schmidt, *supra* note 28, at 884.

⁶¹ *Id.*

⁶² *Id.* at 885.

and bring them back the next day as independent contractors. The workers perform essentially the same tasks, but the employer is no longer liable for the costs inherent in a traditional employment relationship.⁶³ Other employers require a worker to go through a ninety day conditional period before being recognized as an “employee.” Employers who operate creatively (for lack of a better term) can terminate these workers on their eighty-ninth day in order to stop the worker from realizing full employee status.⁶⁴ Microsoft’s corporate policy limits an independent contractor to one year of work with the company, at the end of which the worker is required to wait 100 days before re-contracting with Microsoft.⁶⁵ Although this functions as a solution to the continual hiring/firing/re-hiring cycle, it is facially detrimental to the worker, who is virtually un-hirable for over three months.

b. Misclassification in New York State

“Misclassification costs New York State millions of dollars each year. Addressing this issue protects workers and law-abiding employers and collects much-needed state revenues.”⁶⁶

Government and citizens suffer when workers are misclassified as independent contractors. When workers are not protected by the aforementioned federal statutes, the consequences include lower wages, longer hours, and more hazardous work conditions. As employers discover that misclassification is a creative way to get workers to perform more for less pay, regular employees consequently suffer a general depression of wages and

⁶³ GREENHOUSE, *supra* note 8, at 118.

⁶⁴ *Id.*

⁶⁵ LANCE COMPA, UNFAIR ADVANTAGE: WORKERS’ FREEDOM OF ASSOCIATION IN THE UNITED STATES UNDER INTERNATIONAL HUMAN RIGHTS STANDARDS 167 (2000).

⁶⁶ ANNUAL REPORT OF THE JOINT ENFORCEMENT TASK FORCE ON EMPLOYEE MISCLASSIFICATION 6 (2009) [hereinafter JOINT ENFORCEMENT].

loss of bargaining power of their own. An increasing number of employers prefer the cheap use of independent contractors over the more costly hiring of full-time employees.

Citizens also suffer in the form of lost revenue to the state, known as the “tax gap.”⁶⁷ A large percentage of the tax gap in the United States is due to the nonpayment and underpayment of Social Security tax, unemployment tax, and income tax because of worker misclassification. Unfortunately, the last comprehensive estimate of the tax gap was performed by the IRS in 1984, when the worker misclassification portion was estimated to reach \$1.6 billion.⁶⁸ The GAO updated this amount to \$2.72 billion in 2006 to reflect inflation, but it is reasonable to assume that with the increasing use of independent contractors since 1984, the tax gap amount is much higher today.⁶⁹

In New York State, approximately 10% of workers are misclassified every year.⁷⁰ The state’s tax gap attributable to misclassification has not been cumulatively totaled. A report from the Cornell University School of Industrial and Labor Relations auditing a select number of industries estimated that unemployment taxes *alone* were underreported by over \$175 million from 2002-2005.⁷¹ This amount does not take into account the underreporting of Social Security taxes and income taxes. Although this estimate is more recent than the IRS’ approximation from 1984, the increasing use of independent contractors means that the amount of underreported tax revenue must have increased even since 2005. Further, the estimate of \$175 million reflects only a

⁶⁷ TREASURY INSPECTOR GEN. FOR TAX ADMIN., WHILE ACTIONS HAVE BEEN TAKEN TO ADDRESS WORKER MISCLASSIFICATION, AN AGENCY-WIDE EMPLOYMENT TAX PROGRAM AND BETTER DATA ARE NEEDED 1, No. 2009-30-035 (2009). The tax gap is “the difference between the amount of tax that taxpayers should pay and the amount that is paid voluntarily and on time.” *Id.*

⁶⁸ *Id.* at 8.

⁶⁹ U.S. GOV. ACCOUNTABILITY OFFICE, EMPLOYEE MISCLASSIFICATION: IMPROVED OUTREACH COULD HELP ENSURE PROPER WORKER CLASSIFICATION 2 (2006).

⁷⁰ DONAHUE ET AL., *supra* note 7, at 5.

⁷¹ *Id.* at 2.

select number of audited industries, and not the entire workforce. The problem of worker misclassification – and the consequential drop in state revenue – is a growing problem in New York State.

IV. REGULATION

a. Efforts of the Federal Government

Most federal regulation of worker misclassification is handled by the United States Department of Labor (DOL). In general, a misclassification case begins as a worker complaint made directly to the DOL. If the agency investigates the complaint and it is found to be accurate, the employer will be responsible for the appropriate remedy, including the remuneration of unreported or underreported taxes and any accompanying penalties.

Upon Congressional request, the Government Accountability Office (GAO) reviewed DOL actions in the area of worker misclassification and reported the results to the Senate Committee on Health, Education, Labor, and Pensions in July 2006.⁷² The GAO revealed that while the majority of DOL investigations occurred as a result of a worker complaint, the agency was not effective in providing guidance for misclassified workers.⁷³

First, the GAO report criticized the agency's effort to educate American workers on the possibility that they may be missing out on important rights and protections because they are misclassified. Second, it found that existing agency guidance was insufficient to help the American worker. The GAO report cited a commonly used DOL workplace poster on misclassification that lacks a hotline telephone number for the worker to make a complaint.⁷⁴

The GAO report also raised concern that the DOL does not always forward complaints to other relevant agencies.⁷⁵ For

⁷² See GAO, EMPLOYMENT ARRANGEMENTS, *supra* note 1, at 1-2.

⁷³ *Id.* at 30-32.

⁷⁴ *Id.* at 31.

⁷⁵ *Id.* at 32-34.

example, a wage and hour law complaint that results in the discovery of misclassified employees should also be forwarded to the IRS for investigation into underpaid taxes. Data sharing is the task of DOL district offices, but there is no standard protocol among the offices for the data sharing process.⁷⁶ The DOL often fails to share data with both federal agencies and state labor and taxation authorities. This lack of shared knowledge translates to a less efficient regulation scheme, as well as an easier opportunity for some employers to continue purposely committing fraudulent misclassification.

In the past, Congress has proposed legislation to clarify the employee-independent contractor distinction, close loopholes in the tax law, and strengthen the available enforcement remedies. The last major proposed bill on this subject was introduced in the 110th Congress on September 12, 2007 by then-Senator Barack Obama (D-IL), Senator Edward Kennedy (D-MA), and others.⁷⁷ The intent of the bill was to mandate that employers post information in the workplace informing independent contractors of the misclassification issue, including their right to make a complaint and challenge their assigned status by receiving an IRS determination on the issue.⁷⁸ The bill was referred to the Committee on Finance, but with no result.⁷⁹

b. Regulation in New York State

The most meaningful regulatory action proposed to fight misclassification in New York has been developed over the past two years, and reflects a sharp contrast from the chaotic federal regulation scheme. In September 2007, then-Governor Eliot

⁷⁶ *Id.* at 33.

⁷⁷ Independent Contractor Proper Classification Act, S. 2044, 110th Cong. (2007).

⁷⁸ Richard J. Reibstein et al., *The Risk of Using Independent Contractors*, N.Y. L.J., May 15, 2008.

⁷⁹ *See id.*

Spitzer ordered the creation of the Joint Enforcement Task Force on Employee Misclassification.⁸⁰ This action made progress where, prior to 2007, the enforcement of proper classification was disjointed.⁸¹ The Governor's Executive Order brought together the Department of Labor, Workers' Compensation Board, Department of Tax and Finance, Attorney General's Office, and Comptroller of the City of New York for the first time, in order to develop and maintain a coordinated enforcement plan led by the Commissioner of the Department of Labor.⁸²

Task force efforts include joint enforcement sweeps; forty-six have been completed in New York City, Albany, and Buffalo to date.⁸³ In an enforcement sweep, representatives from each agency coordinate to jointly inspect construction sites, restaurants, hotels, factories, or retail stores. Agency representatives have the authority to demand business records from employers.⁸⁴ Both employers and workers are interviewed during the sweep. These joint enforcement sweeps have resulted in the discovery of over \$2.5 million in underreported unemployment taxes and over \$1 million in fraud penalties.⁸⁵ Upon the discovery of a major fraud case, the Attorney General's Office or local District Attorney's Office may step in to pursue criminal proceedings against the employer.⁸⁶

In addition to joint enforcement sweeps, the agencies represented in the task force are involved in many other aspects of the classification issue, from regulation to outreach. Per the Governor's Executive Order, all of the agencies involved are required to share data with each other.⁸⁷ To that end, a task force

⁸⁰ Press Release, Governor Eliot Spitzer, Governor Spitzer Signs Executive Order to Prevent Employee Misclassification (Sept. 7, 2007) (on file with author)[hereinafter Press Release].

⁸¹ *Id.*

⁸² *Id.*

⁸³ See JOINT ENFORCEMENT *supra* note 66, at 14, 19.

⁸⁴ *Id.* at 15.

⁸⁵ *Id.* at 17.

⁸⁶ *Id.*

⁸⁷ See Press Release, *supra* note 80.

“forms team” is currently revising agency forms so that an inspector from one agency can gather information in a format that is relevant and helpful to the remainder of the task force agencies.⁸⁸ Sections of the task force are also in the process of reaching out to other states to gather more ideas for regulation and enforcement.⁸⁹ Featured among this review is the question of whether New York should switch from the common law right-to-control test to the ABC test, where the worker is presumed to be an employee unless all three factors in the test are proven.⁹⁰ The task force has also been charged with citizen outreach, which it accomplishes by meeting with business, labor, and community groups to provide education on the topic of misclassification.⁹¹ Finally, the task force is required to report its progress to the Governor in an annual report every February.⁹² The progress made by the task force since its inception in 2007 shows that New York is on the right track to address and regulate the increasing misclassification of workers.

V. A DIFFERENT APPROACH

The classification of workers is inherently based on whether each worker fits into the mold of a traditional employment arrangement. Since the restructuring of labor circa World War II, the typical employee was presumed to be one who dedicates a forty hour (or more) work week to one employer with whom he has a lengthy career.⁹³ The traditional relationship, therefore, is a

⁸⁸ See JOINT ENFORCEMENT *supra* note 66, at 22-24.

⁸⁹ *Id.* at 25.

⁹⁰ *Id.* at 25-26. See also *supra* text accompanying note 15.

⁹¹ See JOINT ENFORCEMENT, *supra* note 66, at 24-25.

⁹² See Press Release, *supra* note 80.

⁹³ Guy Davidov, *The Reports of My Death are Greatly Exaggerated: 'Employee' as a Viable (Though Overly-Used) Legal Concept*, in BOUNDARIES AND FRONTIERS OF LABOUR LAW: GOALS AND MEANS IN THE REGULATION OF WORK 133 (2006).

“vehicle [for the employer] to deliver a set of entitlements” earned with time and loyalty.⁹⁴

The employment relationship has been evolving since the 1940s, but the classification scheme for workers has not necessarily kept pace.⁹⁵ A worker that cannot fit the mold of the traditional employment relationship is automatically deemed an independent contractor, entitled to no benefits and no protection under federal law.⁹⁶ This rigid classification scheme leaves out the possibility that although a worker may not be an employee, he or she may be deserving of some or all of the rights that an employee enjoys.⁹⁷ Currently, no third category exists in the classification scheme to accommodate this type of middle-ground worker.

In neighboring Canada, however, the law has carved out room for a third category, separate from employees and independent contractors. The “dependent contractor” is a worker who “whether or not employed under a contract of employment, performs work or services for another person on such terms and conditions that they are, in relation to that other person, in a position of economic dependence on, and under an obligation to perform duties for, that other person.”⁹⁸ A dependent contractor fits the middle ground between an employee and an independent contractor. The main difference between a dependent and

⁹⁴ *Id.* at 135.

⁹⁵ This change is reflected in the increasing use, for example, of 401K accounts, rather than company pensions, allowing the worker more flexibility for retirement savings when transferring from one company to another.

⁹⁶ Guy Davidov criticizes the employment relationship as “exclusionary” for leaving out the non-compensated worker, such as the stay-at-home parent. *See* Davidov, *supra* note 93. This paper does not directly cover his concerns, but his comments further highlight the need to alter the classification scheme to incorporate other workers who do not fit the traditional mold.

⁹⁷ Kenneth Dau-Schmidt suggests the creation of a definition of employee that includes independent contractors, so that all workers may enjoy the same level of rights and protections in the law. *See* Dau-Schmidt, *supra* note 28, at 884. I believe it is more reasonable to maintain some degree of gradation of rights and protections in accordance with the actual circumstances of the working relationship, which is why I propose the third category.

⁹⁸ Canada Labour Code, R.S.C., ch. L 2 (1985).

independent contractor is the emphasis on economic dependence on the employer. Workers that fit into the category of dependent contractor enjoy benefits such as the right to collective bargaining.⁹⁹

The creation of a third category such as “dependent contractor” in the United States would bestow valuable employment rights on individuals now outside of the traditional employer-employee relationship. Under the Canadian Labour Code standard, the FedEx Home Delivery workers may be considered dependent contractors because despite their ability for entrepreneurial gain or loss, they are still financially tied to the employer in reality.¹⁰⁰ As dependent contractors, their collective bargaining rights would be protected under Canadian law.

VI. CONCLUSION

a. Increasing Use of Independent Contractors

Under the current classification scheme, employers in the United States continue to use independent contractors for the purposes of keeping employment costs low, thereby allowing their business to stay more competitive than it might otherwise be. Misclassification of workers continues to be a complex legal issue for employers, especially because the nation’s workforce is dominated by many types of contracts and work schedules, from part-time, to on-call, to freelance, and more.¹⁰¹

⁹⁹ *Id.*

¹⁰⁰ See *FedEx Home Delivery vs. NLRB*, 563 F.3d 492, 516-17 (D.C. Cir. 2009) (Garland, J., dissenting) (arguing that one instance of a driver exercising his entrepreneurial ability is not sufficient to infer that all drivers are independent contractors with the ability and opportunity to exercise such ability).

¹⁰¹ Classification of employees is a topic of growing legal importance. See, e.g., WEST, CORPORATE COUNSEL’S GUIDE TO INDEPENDENT CONTRACTORS (2009) (providing guidance on the various tests for classifying under the IRC, ERISA, NLRA, FLSA, Antidiscrimination Laws, Unemployment Insurance and Worker’s Compensation).

A growing trend further highlights the legal complexity of the issue. Employers are increasingly turning to outside consultants to provide guidance on the issue of worker classification.¹⁰² These consultants are provided with the details of a potential hire, including job description and other documentation. In return, the consultant provides a recommendation back to the business for classifying the worker as either an employee or independent contractor.¹⁰³ The increasing use of independent contractors in the workplace continues to create a market where this type of consultancy will be popular, especially because classification remains a complex, intimidating task for employers.¹⁰⁴

The misclassification trend continues to affect workers who are improperly classified as independent contractors and are not receiving the benefits and protections they are entitled to receive in a traditional employment relationship. There is little available recourse for misclassified workers. They can hire an attorney and bring a private action against the company, or rely on a government agency to enforce the correct classification standard against their employer. The misclassified worker may, of course, voluntarily leave his or her job and seek employment elsewhere. In the current state of the job market, however, the worker may be left with no other option than to continue in an imbalanced and unfair working relationship, rather than face unemployment.

¹⁰² See, e.g., Pro-Unlimited Home Page, <http://www.pro-unlimited.com> (last visited May 10, 2010). Pro-Unlimited is an example of a firm specializing in the management of independent contractor issues.

¹⁰³ It should be noted that many such consultants also provide third-party payroll services for independent contractors. Growth of this side of the business may mean the consultant is motivated to label the worker as an independent contractor, not an employee.

¹⁰⁴ Some consultants also provide advice on gathering documentation to support a finding of independent contractor status, which hints that some employers may primarily use these services to avoid the liability of future reclassification.

b. The Continuing Impact on New York State

Turning to New York State, it is clear that misclassification of workers is a looming issue here. The Joint Enforcement Task Force on Employee Misclassification has made significant progress in fostering cooperation between state agencies in making reclassification a high priority. Reining in misclassification could generate desperately-needed revenue for New York State; however, agency enforcement efforts will be difficult in a time when the Governor is asking state agencies to reduce spending by \$500 million.¹⁰⁵

A larger looming issue is the unsteady balance between government regulation and business activity. Whether intentional or not, an employer who utilizes a “just-in-time” workforce is more agile and flexible, especially in times of low demand. In fact, this flexibility has led to the use of independent contractors becoming customary in many industries, including construction, healthcare, and retail. Increased enforcement may put too much pressure on businesses that are barely surviving the recession. Government intervention could have a devastating effect. If these businesses go under because of increased regulation, can New York State afford to lose more jobs?

¹⁰⁵ Press Release, Office of New York State Governor David Paterson, Governor Paterson Proposes Two-Year, \$5.0 Billion Deficit Reduction Plan to Address Current-Year Budget Gap, Improve New York’s Long-Term Fiscal Stability (Oct. 15, 2009), *available at* http://www.state.ny.us/governor/press/press_1015091.html.